# BACKGROUND AND ISSUES

concerning

# GIFT TAX LEGISLATION PROVIDING

# RELIEF FROM THE DICKMAN DECISION

Scheduled for a Joint Hearing

Before the

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

and the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

of the

SENATE COMMITTEE ON FINANCE

on April 4 and 12, 1984

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of the

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# INTRODUCTION

The Subcommittees on Estate and Gift Taxation and Taxation and Debt Management of the Senate Committee on Finance have scheduled a joint public hearing on April 4, 1984, on legislative proposals to overrule, or limit the retroactive application of, the decision of the Supreme Court in Dickman v. Commissioner, 465 U.S. ___ (1984). In the Dickman case (decided on February 22, 1984), the Supreme Court held that the Federal gift tax applies to the value of the foregone interest on an interest-free or below-market interest rate demand loan.

This document, prepared in connection with the Committee hearing, contains three parts. The first part provides an overview of present law. The second part contains a brief discussion of the issues raised by the legislative proposals. The third part mentions several of such proposals.

# I. BACKGROUND

## Overview of the Federal gift tax

Under present law, a tax is imposed for each calendar year on the transfer of property by gift during such calendar year by any individual. In general, this tax applies to all direct or indirect transfers of real property or tangible or intangible personal property. The amount of the gift is the value of the property transferred at the date of the transfer. If property is transferred for less than adequate and full consideration in money or money's worth, the amount of the gift is excess of the value of the property at the date of the transfer over the value of any consideration received at such date.

Under present law, the gift tax is a progressive tax that is applied to cumulative lifetime transfers.[1] The amount of gift tax payable for any period is computed by determining the amount of tax payable on the taxpayer's lifetime transfers, and then by subtracting the tax payable on the transfers made in prior taxable periods.[2]

The first $10,000 of gifts by a donor to any person during a calendar year are not treated as taxable gifts. For calendar years prior to 1982, the first $3,000 of gifts were not treated as taxable gifts. Under the split-gift rules, a donor and his or her spouse can elect to treat a gift by one spouse to any person other than the other spouse as made one-half by the donor and one-half by his or her spouse. Thus, by taking advantage of the split-gift rules, the annual exemption for a married donor can be as much as $20,000.

In addition, under present law, there is a cumulative lifetime gift tax credit. The amount of this credit for any calendar year is a statutory amount less amounts allowable as credits for all prior taxable periods. For 1984, the

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1 The gift tax is computed and payable on an annual basis for all gifts made during calendar years after 1981 and before 1971. For calendar years from 1971 through 1981, the gift tax was computed and payable on as quarterly basis.

2 Thus, if a taxpayer filed a gift tax return for gifts made in a prior period, but did not include all the gifts in that period on that return, the unreported gift could increase the amount of the tax owed on gifts made during a subsequent period even though a gift tax return had been filed for the prior period and the limitations period had run. See Daanen v. Commissioner, 30 T.C.M. (CCH) 286 (1971).

statutory amount is $96,300. This amount is to increase annually to a maximum of $192,800 for 1987 and subsequent calendar years. A unified credit of $192,800 is the equivalent of a gift and estate tax exemption of $600,000. By taking advantage of the split-gift rules, this exemption equivalent can be increased to $1,200,000.

Generally, a gift tax must be assessed within 3-years after the filing of a gift tax return. No proceeding in a court for the collection of a gift tax can be begun without a prior assessment after the expiration of the 3-year period. If no return is filed, the tax may be assessed, or a suit commenced to collect the tax without assessment, at any time. If a gift tax return is filed for a period, and all gifts made during such period are not reported on the return, the duration of the period during which a tax can be assessed, or a suit commenced without assessment, depends on the amount of the unreported gifts relative to the amount of the reported gifts. If the amount of the unreported gifts is in excess of 25 percent of the amount of the reported gifts, the tax may be assessed, or a suit commenced to collect the tax without assessment, within 6 years after the return was filed.

## Demand or term loans to family members under present law

On February 22, 1984, the Supreme Court decided the case of Dickman v. Commissioner, 465 U.S. ___ (1984). In that case, the Supreme Court held that under present law an interest-free or below-market interest-rate demand loan by one family member to another family member (referred to herein as a below-market loan) resulted in a gift for Federal gift tax purposes.[3]

Prior to the Dickman decision, current law was reflected in Rev. Rul. 73-61, 1973-1 C.B. 408, issued by the Internal Revenue Service in 1973 holding that below-market loans resulted in gifts for Federal tax purposes, and several court decisions that reached inconsistent results.

Rev. Rul. 73-61, 1973-1 C.B. 408, involved a transaction

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3 In Dickman, the Supreme Court did not reach the question of the valuation of the gift. In dicta, however, the Court stated that "to support a gift tax. . . . the Commissioner need not establish that the funds lent did in fact produce a particular amount of revenue; it is sufficient for the Commissioner to establish that a certain yield could readily be secured and that the reasonable value of the use of the funds can be reliably ascertained."

in which a parent negotiated a loan with a bank requiring the payment of interest at an arms-length rate. Shortly thereafter, the parent made a loan to a corporation controlled by his son in exchange for interest-free demand and term notes. The Internal Revenue Service ruled that the right to use property, including money, "is itself an interest in property the transfer of which is a gift" for Federal gift tax purposes "unless full and adequate consideration in money or money's worth is received." Further, the Service ruled that, in the case of a term loan, the amount of the gift is the value of the right to the use of the money as of the date the money and the note are exchanged computed under accepted actuarial methods. In the case of a demand loan, because the borrower has the right to use the money only so long as the lender does not demand payment, the amount of the gift is the value of the use of the money for such portion of the year as the lender allows the borrower the use of the money.

In Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966), the taxpayers made large interest-free demand loans to their children during the years 1956 through 1962. The loans were bona fide and most were repaid. The Internal Revenue Service asserted that the taxpayers had made gifts to their children in an amount equal to the value of the use of the money loaned for the period during which each of the loans was outstanding. The District Court for the Northern District of Texas held that the loans did not result in gifts for Federal gift tax purposes.

In Crown v. Commissioner, 67 T.C. 1043 (1977), the Tax Court held that interest-free demand loans by a partnership to relatives of the partners (and trusts for the benefit of such relatives) did not result in gifts for Federal gift tax purposes. The United States Court of Appeals for the Seventh Circuit affirmed the decision of the Tax Court (585 F. 2d 234 (1978)). The Internal Revenue Service announced that it would not follow that Crown decision (1978-1 C.B. 2).

The case of Dickman v. Commissioner, T.C.M. 1980-575 (CCH) (1980), involved interest-free demand and term loans made to a relative and to a closely held corporation controlled by the relative during the years 1971-1976. Citing Crown, the Tax Court held that the interest-free loans did not result in a gift for Federal gift tax purposes. The United States Court of Appeals for the Eleventh Circuit reversed the Tax Court and held that the loans resulted in taxable gifts under present law in amounts equal to the value of the right to use the loan proceeds for the period during which the loans were outstanding. As discussed above, the Supreme Court resolved the conflict between the Seventh and Eleventh Circuits holding that interest-free loans result in a gift for Federal gift tax purposes under present law.

All the cases that have considered the treatment of below-market term loans have held that such loans result in gifts for Federal tax purposes. In each case, the amount of the gift, which is deemed to occur at the time the loan is made (i.e. on the exchange of the money and the note), is the excess of the amount of the loan over the present value of the principal and interest payments due under the loan. See Blackburn v. Commissioner, 20 T.C. 204 (1953); Mason v. United States, 365 F. Supp. 670, aff'd 513 F. 2d 25 (1975); Estate of Berkman, 38 T.C.M (CCH) 1083 (1979); Dickman v. United States, supra; and Rev. Rul. 73-61, supra.

## Proposed legislation

The Committee has approved legislation that, in substance, would codify the holding of the Supreme Court in Dickman and provide for the income tax treatment of below-market loans. The proposed legislation would treat the parties to a below-market loan as if they had made a loan bearing a market rate of interest and the lender had made a gift of money which is used to pay the interest. Under this proposed legislation, the payment of interest is included in income by the lender and deductible by the borrower to the extent that an actual payment would be deductible.

The proposed legislation would be effective with respect to amounts outstanding on loans after the date of enactment except to amounts outstanding on term loans made before February 1, 1984.

## II. ISSUES

The proposals which are the subject of the hearing would overrule, or otherwise limit the retroactive application of, the Supreme Court's decision in Dickman v. Commissioner, supra, with respect to below-market loans outstanding prior to February 22, 1984. These proposals raise a number of issues.

1. What is the likely effect of the Dickman decision on subsequent estate and gift tax liabilities?

It can be argued that pre-1984 loans should be exempted from the Dickman decision because it will be difficult to know what subsequent estate and gift tax liabilities are since the amount of an individual's estate and gift taxes are dependent on prior gifts. On the other hand, taxpayers who wish such assurance could file gift tax returns for prior years which would start the running of the statute of limitations.

2. What is the amount of the gift in the case of loans covered by the Dickman decision?

It can be argued that the Dickman decision creates significant administrative problems because the amount of the gift may be difficult to determine. Under the Dickman decision, the amount of the gift is the amount of the foregone interest which, in turn, depends upon the credit worthiness of the borrower and the general level of interest rates at the time the loans were outstanding. Since these two items often vary over time, separate determinations of the foregone interest would be required every time one of the two items vary. On the other hand, the determination of the value of a gift is a frequent problem encountered in the gift tax and there are other areas of the law which have the same valuation problems (e.g., sec. 482). Moreover, administrative problems with valuation could be solved by legislation providing an appropriate discount rate (such as is provided in the legislation approved by the Committee for pre-1984 loans).

3. Was it reasonable for taxpayers that have engaged in these transactions to expect that they would not be subject to tax?

It can be argued that taxpayers who made below-market loans were relying in good faith on the 1966 Johnson decision or the 1977 Crown decision and, accordingly, they should not be subject to the gift tax. On the other hand, it can be argued that a below-market loan involves, in substance, an assignment of income and, under general principles of tax

law, such assignments are subject to gift tax. Moreover, the Internal Revenue Service's position has been clear at least since 1973 (Rev. Rul. 73-61, supra.), if not since 1966 (the Johnson case), and that the gift tax should apply with respect to amounts outstanding after taxpayers were on notice of the Service's position.

4. What is the likely effect of retroactive legislative relief on the administration of the tax laws generally?

It can be argued that if relief is provided in this case, relief should be provided in other cases in which the law is not clear. For example, relief should also be provided in other instances in which the Internal Revenue Service has lost one or more cases before the Supreme Court determined that the Service was correct. On the other hand, it can be argued that relief is justified in this case because prior to the Dickman decisions, the two litigated cases were decided favorably to the taxpayers.

## III. POSSIBLE LEGISLATIVE PROPOSALS

There are a number of possible approaches that could be employed to overrule, or otherwise limit the application of, the Supreme Court's decision in Dickman v. Commissioner, supra.

These include:

1. A rule providing that there is no taxable gift for loans outstanding before the date of the Dickman decision (February 22, 1984).

2. A rule providing that there is no taxable gift for loans outstanding on the date the taxpayers were on notice of the Service's position (1966 or 1973).

3. A rule providing that there is no taxable gift on small loans (e.g., less than $100,000).

4. A rule providing an election for taxpayers to apply the new proposed statutory provisions to amounts outstanding prior to the enactment of the new rules.

5. A rule providing that there is no taxable gift if the loan is rewritten within a short period after the date of enactment to require the payment of interest at an adequate rate.